No. 378

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HAROLD B. WILLEY, C

IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

THE FIRST NATIONAL BANK,
Petitioner,

—against—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

FIRST NATIONAL BANK, *Petitioner,* —*against*— COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable The Chief Justice and the Associate Justices of the United States:

The petitioner prays the issuance of a writ of certiorari to the United States Court of Appeals for the Second Circuit to review the judgments and decisions of that Court rendered on May 11, 1955 and June 7, 1955, affirming an order of the Tax Court of the United States on the opinion of the Tax Court promulgated on April 30, 1954 and denying a petition for rehearing.

Citations to Opinion and Decisions Below

The opinion of the Tax Court is reported in 22 T. C. 209, and appears at R. 72. It is printed in the appendix to petitioner's brief below. The decision of the Court of

Appeals for the Second Circuit is reported in 221 F. 2d 959.

Jurisdiction

The judgment of the Court below denying the petition for rehearing was entered on June 7, 1955. The jurisdiction of this Court is invoked under Sections 1254 and 2101 of the Judicial Code, effective September 1, 1948 (28 U. S. C.).

Questions Presented

1. Whether in computing a bad debt "recovery exclusion" under Section 22(b)(12) of the Internal Revenue Code of 1939, and the extent to which the deduction on account of the bad debt did not result in tax benefit, the true net loss for the year of the deduction should be considered or only the net loss as reported on the return for that year after the statute of limitations for filing refund claims and assessing deficiencies has run on such year?

2. In Section 22(b)(12)(D) do the words "did not result in a reduction of taxpayer's tax" indicate that Congress intended, in providing an income tax exclusion for a bad debt recovery to the extent that no tax benefit was derived from the deduction of the bad debt, to bar consideration of additional items of income, deduction and exclusion not reported on the return for the year in which the bad debt was deducted after the statute of limitations for filing refund claims and assessing deficiencies has run on such year?

3. Does the fact that the statute provides a recovery exclusion only with respect to bad debts for which a deduc-

tion was allowed for a prior taxable year indicate that Congress intended only allowed deductions and exclusions to be considered in determining the tax benefit derived by the bad debt deduction?

Statute Involved

The statute involved is Section 22(b)(12) of the Internal Revenue Code of 1939 and is set forth in the appendix hereto.

Statement

The facts are not in dispute. The petitioner in 1937 charged off an unpaid loan as a bad debt and claimed it as one of the income tax deductions on its 1937 return. The excess of all deductions and exclusions claimed in the 1937 return over income reported resulted in a net loss on the return of $6,023.35. Petitioner had more items of exclusion and deduction (not attributable to bad debts, prior taxes and delinquency amounts) which, although concededly allowable, were not excluded or deducted in the return. Taking these items into account, petitioner's net loss for 1937 was $19,254.74.

In 1949, when the statute of limitations for making refund claims or assessing deficiencies had run on 1937, a recovery on the bad debt was realized. Petitioner maintains that part of this recovery should be excluded from 1949 income under Section 22(b)(12) of the Internal Revenue Code of 1939 for although the recovery together with other previous recoveries of bad debts deducted in the 1937 return exceeded the net loss shown on the 1937 return, considering the true loss in 1937 the petitioner realized no tax benefit to this extent on account of the bad debt deduction with respect to this recovery.

The Tax Court held that the petitioner was not entitled to a recovery exclusion under Section 22(b)(12) because the statute defines "recovery exclusion" to be the amount of a deduction allowed on account of the bad debt "which did not result in a reduction of the taxpayer's tax". The Tax Court interpreted this to mean that the exclusion must be based on the 1937 return as filed and that no change in the net loss shown on the return can be considered for the purpose of determining the tax benefit and recovery exclusion after the statute of limitations for filing claims for refund or assessing deficiencies has run on 1937, the year in which the bad debt was deducted. The Court of Appeals affirmed the order of the Tax Court on the opinion of the Tax Court and denied a petition for rehearing.

Reasons for Granting the Writ

1. The decision below, although adverse to the taxpayer here, may seriously prejudice the Commissioner of Internal Revenue in future cases involving the precise issue.

Petitioner, like most taxpayers, wishes to pay no more tax than is due. However, petitioner is also concerned in protecting the interests of its Commissioner of Internal Revenue and in preventing any serious hindrance to the effective administration of the tax laws. Because of the relatively small amount of tax involved in the present case, this latter concern as well as the former has been a principal reason for the time, effort and expense of appealing the decisions of the courts below.

The instant case presents a question whose resolution will have immediate importance far beyond the particular facts and taxpayer involved. A very important principle is in issue upon which the rights and revenue of a great many

taxpayers throughout the country depend. It is whether taxpayers may show the true facts with regard to their tax liabilities and whether the Commissioner of Internal Revenue is barred from reaching those true facts in the absence of clear statutory authority to the contrary.

The Tax Court and the Court of Appeals held that for the purpose of computing the tax benefit from a bad debt deduction and the recovery exclusion under Section 22(b)(12) of the Internal Revenue Code of 1939, no consideration can be given to items of income, deduction or exclusion after the statute of limitations has run on the year in which the deduction was claimed.

Such a rule once established must work both ways, preventing the Commissioner from going behind the statute of limitations in adjusting a loss in an earlier year claimed as the basis for a recovery exclusion. For example, if in an earlier year a taxpayer in his return claims an improper deduction on account of a bad debt or fails to report proper items of income, and on audit of the return the Commissioner fails to correct such errors or fails to audit the return at all, the Commissioner when the statute of limitations has run is barred from correcting the earlier errors by assessing a deficiency and is also barred from disallowing a recovery exclusion in the year of recovery. Furthermore, even if the Commissioner in auditing the earlier return discovers an error before the statute of limitations has run, there is nothing he can do about correcting it on the return if after the correction the return would show a net loss for the Commissioner can assess a deficiency only if there is no net loss.

2. The decision below imposes an undue burden on taxpayers. The Internal Revenue Code requires a taxpayer to report the amount of tax due in any year. In years in

which the taxpayer has losses, he has no tax. In these loss years he is neither motivated nor obligated to list on his tax return every possible deduction or exclusion since any additional deduction or exclusion cannot reduce his tax less than nothing. The effect of the decision below is to force all taxpayers in the future to claim on every return all deductions and exclusions, whether needed or not to eliminate taxable income.

It is believed that Congress never intended such results and that under a proper interpretation of the statute taxpayers are to be permitted to present evidence of additional deductions in prior years in computing a recovery exclusion so that the true tax benefit derived in those years can be determined. The decision below is as novel as it is far-reaching and clearly calls for review by this Court.

3. The decision of the Court of Appeals conflicts with applicable decisions of this Court. The Tax Court decided the case and the Court of Appeals affirmed on the theory that where the statute of limitations has run on the year in which a bad debt was deducted and a recovery of the bad debt occurs in a later year, a recovery exclusion is permitted only upon the basis of the return as filed for the earlier year without regard to the true facts in the earlier year. The issue before the Court was whether the petitioner for the year 1949 was entitled to a recovery exclusion under Section 22(b)(12) of the Internal Revenue Code of 1939 resulting from a recovery of a debt previously charged off in 1937. The statute excludes from gross income recoveries of previously deducted bad debts to the extent that the prior deduction "did not result in a reduction of the taxpayer's tax". Under the statute, therefore, when the "prior deduction" occurred in a year in which the taxpayer sustained a loss, the taxpayer can show that it had no tax benefit if

there would have been a net loss for the year without the bad debt deduction.

Under an unbroken line of cases from *Lewis* v. *Reynolds,* 284 U. S. 281 (1932), to *Commissioner* v. *Van Bergh,* 209 F. 2d 23 (2d Cir. 1954), this Court and other courts have consistently held that when a taxpayer files a claim for refund, the Commissioner may examine the entire return for the year involved and assert offsetting adjustments, even though the statute of limitations has already run by the time the Commissioner makes his determination. Conversely, when the Commissioner asserts a deficiency against a taxpayer, the taxpayer may, even after the year is barred by the statute of limitations for claiming refunds, claim offsetting adjustments in that year. The principle involved in both these instances is that net refunds or deficiencies are based on the true tax for the year involved. The decision by this Court in *Bull, Executor* v. *United States,* 295 U. S. 247 (1935), is to the same effect. The Tax Court and the Court of Appeals have violated this principle in interpreting the statute so as to deny the petitioner the right to show the true facts for the year 1937, and the decision below conflicts with all the decisions of this Court and other courts establishing the principle.

4. The decision below interprets Section 22(b)(12) of the Internal Revenue Code of 1939 in a manner which is inconsistent with the administrative practice of the tax laws and with other sections of the Internal Revenue Code. The case, therefore, presents an important question of statutory interpretation. Cases will continue to rise under this section of the Internal Revenue Code of 1939 and under the corresponding section of the Internal Revenue Code of 1954 and under future revisions of the Code.

The Tax Court in its opinion attempted to ascertain the intent of Congress with respect to Section 22(b)(12) from the language of the statute, the legislative history, and from general principles with respect to the administration of the tax laws. The result reached, however, is nowhere expressed in or required by the statute, the legislative history, or the administrative practice. The only "evidence" of an intent of Congress to place such a restriction as found by the courts below on the recovery exclusion provided in Section 22(b)(12) is the fact that the recovery exclusion is limited to bad debts "allowed" in a prior taxable year, and that "recovery exclusion" is defined to be the amount which "did not" result in a reduction of the taxpayer's tax. These are certainly not clear enough indications to demand such a novel and far-reaching result or to justify reading the words "taxpayer's tax" in Section 22(b)(12)(D) of the statute as tax reported on an income tax return filed for the earlier year and "tacitly approved" by the Commissioner.

There is not a particle of justification in the statute for concluding that because no change could be made in the bad debt deduction for 1937 since the statute refers only to those bad debts for which a deduction was "allowed for a prior taxable year" that there can be no change in other deductions in computing the tax benefit that has been derived. Congress intended to make it clear in the statute that a recovery exclusion is permitted only with respect to a bad debt which has been claimed as a deduction in a prior year. Prior to the enactment of the statute the Commissioner had taken the position that a recovery of a bad debt which was allowable but not deducted in a prior year was taxable income in the year of the recovery. Congress in enacting Section 22(b)(12) clearly intended to tax the

recovery of a bad debt only to the extent that tax benefit was derived from a deduction of the bad debt. Since no tax benefit could possibly be derived from a bad debt which although allowable was not deducted and "allowed", no recovery exclusion was necessary except for "allowed" bad debts, and it would have made no sense to provide one for "allowable" bad debts. Since no benefit could be derived from an "allowable" as distinguished from an "allowed" bad debt, there would be no use for a taxpayer to attempt to obtain a recovery exclusion by changing the bad debt deduction as reported on the return. There is no reason, therefore, for the inference drawn by the courts below from the definition of "bad debt" in Section 22(b)(12)(A).

The Tax Court pointed out that Section 22(b)(12)(D) defines "recovery exclusion" as the amount of a bad debt deduction "which did not result in a reduction of the taxpayer's tax", and that in the legislative history of the provision the expression "did not in any prior year reduce his income tax liability" or its equivalent appears several times. The courts below reasoned that these words "did not" indicate that Congress meant to bar consideration of additional items of income, deduction or exclusion not reported in the tax return for the year in which the bad debt was deducted after the statute of limitations has run on such year. The Tax Court said that the petitioner is bound by the return which was filed for 1937 and which was "tacitly approved by the Commissioner" (the return was audited but no change made), and it may not now show that the amount which "did not result in a reduction" of its income tax for 1937 was in excess of the net loss shown on the 1937 return. The Tax Court reached this conclusion by reasoning that in order for the petitioner to be entitled to a recovery exclusion the statute would have to be read "would not have

resulted in a reduction of the taxpayer's tax". The Tax Court said that this result was required because the petitioner *might have* included its additional deductions in the return and that the return *might have* shown for 1937 a larger loss than it did. This is very strained reasoning. It is just as easy, and more natural, to read the phrase "did not result in a reduction of the taxpayer's tax" to mean that looking at the true facts for the year 1937 the taxpayer is entitled to a recovery exclusion only to the extent that the deduction for the bad debt in 1937 did not result in any tax benefit. The "taxpayer's tax" is certainly not any figure reported on an income tax return, even though the statute of limitations for filing refund claims or assessing deficiencies for that year has run. The "taxpayer's tax" for computing a recovery exclusion must mean the taxpayer's true tax. As a matter of English and of semantics "did not" when used in the phrase "did not result in a reduction of the taxpayer's tax" more properly means did not result in a reduction of taxpayer's true tax than it does did not result in a reduction of the taxpayer's tax as reported on the return filed by the taxpayer and "tacitly approved" by the Commissioner.

In numerous sections of the Internal Revenue Code of 1939, when Congress wanted to limit the adjustments for a prior year it specifically wrote such limitations into the statute. Sections 22(e)(6), 452, 734(d) and 3801 are examples where such provisions appear. It is apparent from these provisions that Congress on numerous occasions prior to the enactment of Section 22(b)(12) had considered limitations such as the Tax Court suggests and had written them into the statute when it intended to impose such limitations.

The Commissioner's regulations, Regulations 111, Section 29.22(b)(12)-1, indicate that a "computation" for the purpose of the "recovery exclusion" is necessary. Also the logical reference of the word "tax" in the regulations like in the statute is to the correct tax for the year of loss.

The Tax Court's reasoning that there should be a terminal date to establish the taxability of any given year is not applicable in these recovery exclusion cases since Congress specifically made an exception to the statute of limitations by enacting Section 22(b)(12). The recovery exclusion statute provides taxpayers relief from the statute of limitations by granting an income exclusion on the recovery of a bad debt even though the statute of limitations has run on claiming refunds with respect to the earlier year in which the bad debt was deducted.

As a matter of statutory construction, therefore, it would seem crystal clear that the petitioner is entitled to a recovery exclusion. Nor is there anything in the legislative history of the statute evidencing a different intention. Moreover, the rule established by the decision below will create a hardship for taxpayers and the Commissioner of Internal Revenue alike, which Congress certainly must never have intended.

Conclusion

The Court of Appeals decisions affirming the Tax Court and denying the petition for rehearing are in conflict with applicable decisions of this Court, attribute unwarranted restrictions to Section 22(b)(12) of the Internal Revenue Code of 1939 and to corresponding sections under successive revenue acts and raise a question of continuing public importance in the administration of Federal tax law. A

writ of certiorari to review the decisions with a view of reaching a fair and equitable rule applicable to taxpayer and Commissioner alike in these recovery exclusion cases should therefore be granted.

Respectfully submitted,

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New York, N. Y., September 2, 1955

APPENDIX

Section 22(b) of the Internal Revenue Code of 1939 provides as follows:

"(b) Exclusions from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

(12) Recovery of bad debts, prior taxes, and delinquency amounts.—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

(A) Definition of bad debt.—The term 'bad debt' means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(B) Definition of prior tax.—The term 'prior tax' means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(C) Definition of delinquency amount.—The term 'delinquency amount' means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(D) Definition of recovery exclusion.—The term 'recovery exclusion', with respect to a bad debt, prior tax, or delinquency amount, means

the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph."

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

CALENDAR NO. 155—OCTOBER TERM, 1954

Argued April 22, 1955 Decided May 11, 1955

FIRST NATIONAL BANK,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Before: FRANK, MEDINA and HINCKS, Circuit Judges.

Appeal from an order of the Tax Court of the United States, per Judge Murdock. AFFIRMED.

JOHN A. REED and FRANCIS E. RINEHART,
for Petitioner

H. BRIAN HOLLAND, ELLIS N. SLACK and
DUDLEY J. GODFREY, JR.,
for Respondent.

PER CURIAM:

The order of the Tax Court is affirmed on the opinion of Judge Murdock, reported in 22 T. C. 209.

Filed 6/7/55

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

FIRST NATIONAL BANK,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Before: FRANK, MEDINA and HINCKS, Circuit Judges.

On Petition for Rehearing.

JOHN A. REED and FRANCIS E. RINEHART,
Attorneys for Petitioner

PER CURIAM:

Petition for rehearing denied.

/s/ JEROME N. FRANK
Jerome N. Frank, U. S. C. J.

/s/ HAROLD R. MEDINA
Harold R. Medina, U. S. C. J.

/s/ CARROLL C. HINCKS
Carroll C. Hincks, U. S. C. J.

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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 378

THE FIRST NATIONAL BANK, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 2a-7a)[1] are reported at 22 T.C. 209. The *per curiam* opinion of the Court of Appeals (Pet. 15) is reported at 221 F. 2d 959.

JURISDICTION

The judgment of the Court of Appeals was entered on May 11, 1955. A petition for rehearing

[1] Record references are to the Appendix to the taxpayer's brief in the Court of Appeals. Supplemental record references are to Appendix B to the Commissioner's brief in the Court of Appeals.

was denied on June 7, 1955. (Pet. 16.) The time for filing a petition for a writ of certiorari was extended to and including September 15, 1955, by order of Mr. Justice Burton dated September 6, 1955. The petition for a writ of certiorari was filed on September 8, 1955. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

This case deals with the right of a taxpayer to exclude from income a portion of its recovery of bad debts, pursuant to Section 22(b)12 of the Internal Revenue Code of 1939 permitting the exclusion from income of the recovery of bad debts previously charged off to the extent the prior deduction did not result in a reduction in tax. Specifically, the question is whether the determination of the taxpayer's benefit from the bad debt deduction is to be based on the taxpayer's return for the earlier year or whether additional deductions and exclusions may now be used to change the extent of the tax reduction resulting from the bad debt deduction.

STATUTE INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 are:

SEC. 22. GROSS INCOME.

* * * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross

income and shall be exempt from taxation under this chapter:

* * * * *

(12) [As added by Section 116(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Recovery of bad debts, prior taxes, and delinquency amounts.*—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

(A) *Definition of Bad Debt.*—The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

* * * * *

(D) *Definition of Recovery Exclusion.*—The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduc-

tion of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

(26 U.S.C. 1952 ed. 22.)

* * * * *

STATEMENT

The material facts, as stipulated and found by the Tax Court (R. 2a-4a, 9a-12a), may be summarized as follows:

The taxpayer reported a net loss of $6,023.35 on its corporation income and excess profits tax return for 1937. The Commissioner made no changes in the income, deductions, or tax for that year. Shown as deductions on that return were bad debts aggregating $58,933.17. (R. 2a, 9a-11a.) The tax benefit allowed the taxpayer upon the charge-off of the bad debts therefore amounted to $52,-909.82 ($58,933.17 minus $6,023.35). (R. 11a.)

If the taxable income of the taxpayer for 1937 were now recomputed to take into account allowable items of exclusion and deduction not taken on its 1937 return, the resulting net loss would be $19,254.74 (R. 3a-4a, 11a), and the tax benefit would be $39,678.43.

During the years 1938 to 1948, inclusive, the taxpayer recovered a total of $18,566.01 on the $58,-

933.17 bad debt deductions that it claimed and was allowed for 1937. In 1949, the taxpayer recovered an additional $2,018.22. (R. 2a, 12a.)

Had the taxpayer filed a return for 1937 which took into account all the allowable deductions and exclusions, the amount of bad debts charged off in 1937 which could be recovered in 1949 and not be included in taxable income under Section 22(b)(12) of the Code would be $688.73 ($19,254.74 minus $18,566.01). (R. 2a, 4a, 12a.)

The Tax Court held that the taxpayer was not entitled to exclude this $688.73. (R. 6a, 7a.)[2] The Court of Appeals affirmed on the opinion of the Tax Court. (Pet. 15.)

ARGUMENT

Section 22(b)(12) of the 1939 Internal Revenue Code, *supra*, p. 3, which was added by Section 116(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, provides for the exclusion from gross income of amounts attributable to the recovery during the taxable year of bad debts, to the extent that the deduction of such debts did not operate to reduce the income tax liability of the taxpayer for any prior taxable year, reduced by the amount excludible in previous taxable years with respect to such debt. See H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 69-70 (1942-2 Cum. Bull. 372, 426-427); S. Rep. No. 1631, 77th Cong., 2d Sess.,

[2] This case was reviewed by the full Tax Court; no dissents were noted.

pp. 79-80 (1942-2 Cum. Bull. 504, 565-566); Treasury Regulations 111, Sec. 29.22(b)(12)-1.

Section 22(b)(12) is a relief measure for the benefit of taxpayers who bring themselves within its terms. *Dobson* v. *Commissioner,* 320 U.S. 489, 505. The only question here presented is whether this taxpayer has brought itself within the terms of the statute. Cf. *United States* v. *Olympic Radio & Television,* 349 U.S. 232, 235. We submit that it has not, and both courts below so held.

It is acknowledged (R. 4a) that taxpayer could exclude from its taxable income in subsequent years recoveries on bad debts charged off in 1937 until the recoveries equaled $6,023.35, the net loss shown on its return as filed and accepted for that year; but the courts below rejected (R. 6a) the taxpayer's contention that, notwithstanding the running of the statute of limitations, the year 1937 should be reopened for the purpose of showing that taxpayer had other allowable exclusions and deductions which it might have taken, but did not in fact take, which would increase its net loss to some $19,000 and thus produce a recovery exclusion of $688.73 for 1949.

That contention is without support in the statute, the regulations or the committee reports. There is nothing in any of these to indicate that Congress in passing Section 22(b)(12) intended to lift the bar of the statute of limitations in order to re-determine whether a given deduction for an earlier year produced a tax benefit.

On the contrary, the statutory language indicates that the computation is to be based upon the facts as shown on the return filed for the original year or as made part of the final computation for that year. In this connection the Tax Court aptly said (R. 4a-5a):

> There is not a great deal to indicate what Congress might have intended in a case like this but such indications as appear support the Commissioner. Certainly no change could be made in the bad debt deduction for 1937 because the statute refers to only those bad debts for "which a deduction * * * was allowed for a prior taxable year." It is difficult to believe that Congress meant to allow other deductions or exclusions not shown on the 1937 return when it limited the bad debt, prior tax, and the delinquency amount on which recoveries could be made to the amounts "allowed for a prior taxable year." Section 22(b)(12)(D) defines the "recovery exclusion" as the amount of the deductions allowed for bad debts "which *did not result* in a reduction of the taxpayer's tax under this chapter." [Emphasis supplied.] Likewise, in the legislative history of the provision, the expression "did not in any prior taxable year reduce his income tax liability," or its equivalent, appears several times. These phrases using the words "did not," as contrasted with "would not have" or "could not have" indi-

> cate that Congress meant to accept the final results of the prior years and did not intend that changes, even corrections, could be made after those results had become final. Corrections, if permissible, could work advantages for the Commissioner as well as for the taxpayer and might apply also to the intervening years during which recoveries were made on the bad debts charged off.

And see *Mathey* v. *Commissioner,* 177 F. 2d 259, 264 (C.A. 1), certiorari denied, 339 U.S. 943.

It would require plain statutory authorization, here lacking, to conclude that the bar of the statute of limitations should be lifted in this case, and it makes no difference that in some instances it might be to the advantage of the Commissioner and not the taxpayer to reopen an earlier year.[3] *Rothensies* v. *Electric Battery Co.,* 329 U.S. 296. In that case this Court said (pp. 301, 302):

> It probably would be all but intolerable, at least Congress has regarded it as ill-advised,

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[3] It would, for example, be to the Commissioner's advantage in this case to reopen the year 1941. In computing the gain or loss it realized on the sale of Denver & Rio Grande and Chicago & Great Western bonds during 1941, the taxpayer used as its basis the cost of the bonds. It is agreed that the taxpayer should have used as its basis the cost of the bonds less the amounts it was allowed as bad debt deductions in 1937 due to their having become partially worthless during that year. The taxpayer realized a tax benefit of $29,596.92, through its error. (Supp. R. 25-27.) Unfortunately from the Commissioner's standpoint, the year 1941, like the year 1937, is closed by the statute of limitations.

> to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest. Hence, a statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy.
>
> * * * * *
>
> As statutes of limitation are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them. Both hardships to the taxpayers and losses to the revenues may be pointed out. They tempt the equity-minded judge to seek for ways of relief in individual cases.

The taxpayer relies (Pet. 7) on *Lewis* v. *Reynolds,* 284 U.S. 281; *Bull* v. *United States,* 295 U.S. 247; *Commissioner* v. *Van Bergh,* 209 F. 2d 23 (C.A. 2), but we submit that such reliance is misplaced. In *Lewis* v. *Reynolds,* this Court held that in acting upon a claim for refund based upon the disallowance of a particular deduction, the Commissioner has authority to reaudit the return and to reject the claim on the basis of the disallowance of another deduction even though the statute of limitations prevents him from making an

additional assessment for the year involved. In *Bull* v. *United States,* in a suit by the Government for income tax, the Court held that the taxpayer, by way of recoupment, could successfully assert an overpayment of estate tax, arising from the same transaction, although the statute of limitations would have precluded an independent suit by taxpayer for the refund of the estate tax. In *Commissioner* v. *Van Bergh,* the Second Circuit, applying these decisions in a situation where the taxpayer was admittedly entitled to carry back a net loss to an earlier year under Section 122 of the 1939 Code, held that nevertheless taxpayer was not entitled to a refund for the earlier year if he had in fact underpaid his tax for that year and in this connection the Commissioner was free to rely upon new grounds even if the statute of limitations barred assessment. In the first two of these cases, this Court went behind the statute of limitations only where one taxable year was involved (*Lewis* v. *Reynolds, supra*) or where there was a single taxable event (*Bull* v. *United States, supra*). Recognizing this, the Second Circuit in the *Van Bergh* case took the view that under the provisions of Section 122 relating to carry-backs and carry-overs to certain preceding and succeeding taxable years, Congress intended to treat the loss as a deduction from income in the earlier, or the later, year; and that being so it followed that in determining the right to a refund based upon a carry-

back, the year to which the carry-back was taken could be reopened notwithstanding the statute of limitations.

In the instant case, the *Van Beigh* case was called to the attention of the court below, and it evidently thought its decision there could stand with the one here. We think so, too, for it is clear that there is a real difference between carrying back a net loss under Section 122 and determining the right to a recovery exclusion under Section 22(b)(12). Decision under 22(b)(12) depends upon whether taxpayer derived any tax benefit from deducting the bad debt in the earlier year, but the recovery exclusion for the later year is not an exclusion for the earlier year when the debt was charged off; and there are two separate and distinct events: (1) the debts becoming worthless in the earlier year; (2) the recovery in the taxable year.

The taxpayer criticizes (Pet. 8-10) the Tax Court's conclusion that the statutory language precludes reopening the earlier year. In this connection the taxpayer says that the reason the statute refers to bad debts "allowed" as a deduction in an earlier year is to make it clear that those allowable but not in fact claimed as a deduction cannot constitute the basis for a recovery exclusion.[4] But even if that were so, it would not de-

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[4] Incidentally, the Commissioner appears to have taken the position under pre-1942 law that a recovery on a bad debt

tract from the significance of the word "allowed" which indicates that in determining the question as to tax benefit no consideration should be given to exclusions and credits that were not allowed. Taxpayer also says that the statutory use of the words "did not result in a reduction of the taxpayer's tax" in defining a recovery exclusion does not indicate that Congress was concerned only with the actual tax for the earlier year as contrasted with what it might have been if additional deductions and exclusions had been taken. But taxpayer's argument adds nothing to the natural meaning of the words used. We think it plain from a fair reading of the statute that Congress did not intend to permit the reopening of the earlier year.

Taxpayer's assertion (Pet. 11) that Congress specifically made an exception to the statute of limitations by enacting Section 22(b)(12) is without foundation; and taxpayer's position is contrary to this Court's ruling in *Rothensies* v. *Electric Battery Co., supra.* And see *United States* v. *Garbutt Oil Co.,* 302 U.S. 528, 533-535; *Pacific National Co.* v. *Welch,* 304 U.S. 191, 194.

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previously charged off and *allowed* as a deduction, must be included in gross income for the year in which received. See *Helvering* v. *State-Planters Bank & Trust Co.,* 130 F. 2d 44, 45-46 (C.A. 4th); Treasury Regulations 103, Section 19.23 (k)-1.

CONCLUSION

The decision below is correct and there is no conflict of decisions requiring review. The petition for a writ of certiorari should be denied.

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OCTOBER, 1955.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1955 959666 429

Office - Supreme Court, U.S.
FILED
OCT 27 1955
HAROLD B. WILLEY, Clerk

IN THE

Supreme Court of the United States

OCTOBER TERM, 1955.

No. 378.

THE FIRST NATIONAL BANK,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

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The present case involves no "lifting of the bar of the statute of limitations". This is a misplaced metaphor. No refund is claimed for 1937 and no deficiencies are involved for that year. The only question is how to compute a recovery exclusion for the year 1949 which is not barred by any statute of limitations.

Respondent in his brief says there is no conflict between the decision below and this Court's decisions in *Lewis* v. *Reynolds,* 284 U. S. 281, *Bull* v. *U. S.,* 295 U. S. 274, and the opinion of the Court of Appeals for the Second Circuit in *Commissioner* v. *Van Bergh,* 209 F. 2d 23, because in the cited cases only one taxable year was involved or there was only a single taxable event. In the present case, however, there is also only one year involved, and that year is an open year, 1949. The only taxable event involved

is the recovery in 1949. On the recovery in 1949 of a bad debt written off and deducted in 1937, petitioner is entitled to exclude from taxable income, as a return of principal, that part of the recovery from which he derived no tax benefit. Obviously one must look to 1937. The only question is whether to look to the true facts for that year or only to the return as filed for the year.

Mathey v. *Commissioner*, 177 F. 2d 259, 264 (CA 1), cited by respondent, at most only holds that no recovery exclusion is available where the bad debt recovered was not deducted and allowed. The Court said:

> "And the taxpayer has wholly failed to show that he took any tax deduction for the years prior to 1944 on account of United's infringement, to say nothing of showing that such a deduction resulted in no tax benefit to him."

If anything, this would indicate that the taxpayer does have the right to show that a bad debt deduction previously taken resulted in no tax benefit to him. In the present case the only tax benefit petitioner could have had is a hypothetical one. There is nothing hypothetical, however, about the tax petitioner has paid just to recover part of a sum it loaned. It is submitted that in the absence of any real tax benefit such a taxation of the return of capital is beyond the powers granted Congress by the Sixteenth Amendment to the Federal Constitution. The effect of the decision below is to interpret the statute involved in a manner which renders it unconstitutional.

Respondent's footnote at page 8 overlooks the point made in our petition for rehearing below that the Commissioner is taking an inconsistent position in this very same matter in 1944 and 1945 with respect to the 1941 loss. Claims for refund filed by the taxpayer for 1944 and 1945,

based on recovery exclusions for those years, on account of the 1941 loss as reported in the 1941 tax return, have been denied, the Commissioner readjusting the loss in the return on the basis of the true facts even though the statute of limitations has run on 1941. This is but another example of the confusion which now exists and will continue to exist if the decision below in this case is permitted to stand.

The respondent does not deny or attempt to refute the public importance of the instant case in the administration of the Federal tax laws. Nor does the respondent deny that the decision below presents an important and continuing question of statutory interpretation. Moreover, in attempting to distinguish *Lewis* v. *Reynolds, Bull* v. *U. S.* and *Commissioner* v. *Van Bergh, supra,* respondent's brief only points up the conflict between those cases and the decision below. Respondent's argument in his brief does not set forth any valid reason why the case is not one of the type which this Court should review.

If the decision below stands, the case will have to be distinguished continually, leaving taxpayers, courts and the Commissioner equally confused. The law will be one way with respect to refund or deficiency assessment net recoveries and another way with respect to bad debt recoveries. There are numerous cases to the effect that when the Commissioner asserts a deficiency against a taxpayer, the taxpayer may, even after the year is barred by the statute of limitations for claiming refunds, claim offsetting adjustments in that year. *Barry* v. *Commissioner,* 1 B. T. A. 156 (1924), acq. IV-2 C. B. 1; *Gutterman Strauss Co.* v. *Commissioner,* 1 B. T. A. 243 (1924), acq. V-1 C. B. 1; *Kling* v. *Commissioner,* 1 B. T. A. 1048 (1924), acq. IV-2 C. B. 1; *Hickory Spinning Co.* v. *Commissioner,* 1 B. T. A. 409 (1924), acq. IV-2 C. B. 1; *Hyams Coal Co.* v. *Commissioner,* 1 B. T. A. 217 (1924), acq. IV-1 C. B. 2;

Howard Sheep Co. v. *Commissioner,* 1 B. T. A. 966 (1924); *Columbia Textile Co., Inc.* v. *Commissioner,* 2 B. T. A. 472 (1925); *Auerbach* v. *Commissioner,* 2 B. T. A. 67 (1925), acq. IV-2 C. B. 1; *Jackman* v. *Commissioner,* 2 B. T. A. 515 (1925); *Metzger* v. *Commissioner,* 5 B. T. A. 1230 (1926), acq. VI-2 C. B. 5; *Frischkorn* v. *Commissioner,* 7 B. T. A. 431 (1927), acq. VII-1 C. B. 11.

Our assertion that Congress specifically made an exception to the statute of limitations by enacting Section 22(b)(12) has foundation. The facts occurring in the prior year, even though that year may be barred by limitations, are made determinative of the taxability of the recovery in the year in which it occurs. See *Helvering* v. *State Planters Bank & Trust Co.,* 130 F. 2d 44 (4th Cir. 1942).

We sincerely believe that certiorari should be granted to resolve the existing conflict between the decision below and the applicable decisions of this Court, to determine an important question of statutory construction and to arrive at a fair and equitable rule for the guidance of taxpayers, courts and the Commissioner in recovery exclusion cases.

Dated: October 25, 1955.

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